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IN THE

Supreme Court of the United States

October Term, 1953.

No. **455**

PHILIP WEISS,

Petitioner,

against

JAMES W. JOHNSON, Collector of Internal Revenue.

Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

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THE REPORTER COMPANY, INC., New York City—1953

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In the

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No.

Philip Weiss, Petitioner, against James W. Johnson, Collector of Internal Revenue.	

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Petitioner respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above-entitled case on August 19, 1953 (R. 423) affirming the judgment of the United States District Court for the Southern District of New York.

Opinion Below.

The District Court filed no opinion. The opinion of the Court of Appeals (R. 417-423) is reported in 206 F. 2d 350.

Jurisdiction.

The jurisdiction of this Court is invoked under 28 U. S. C. A., Section 1254 (1).

Question Presented.

In this family partnership test case there is presented the question which was expressly left undecided at the close of this Court's opinion in *Commissioner of Internal Revenue v. Culbertson*, 337 U. S. 733, where at page 748, this Court stated:

> "* * * No question as to the *allocation of income between capital and services* is presented in this case, and we intimate no opinion on that subject."*

This writ of certiorari is also sought to obtain a determination of the following questions:

1. Whether there was in 1942, 1943 or 1944, any legal requirement, in a bona fide partnership, for the partners' agreement to allocate the unknown future net income according to some objective legal formula as between partners' services and partners' invested capital? Also, if there were a loss, would the same formula be applied?

2. Whether the Commissioner of Internal Revenue may, after acknowledging the validity of a family partnership and where the division of profits is not wholly unreasonable, set aside the agreement of the partners and reallocate the income according to his own judgment between capital and services?

3. Whether this Court should resolve the conflict of opinion of the Court below (R. 417-423) with the Courts of Appeal in other circuits and the Tax Court of the United States? The latter Courts have held that where a family partnership is bona fide, the Commissioner and the Courts may not disregard the partners' own profit-sharing and salary arrangements.

4. Whether the meaning of "*Reasonableness of Agreed Division of Profits*" permits the substitution of *reason-*

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* All italics ours unless otherwise indicated.

ableness of return on capital invested, in construing Internal Revenue Bulletin Mim. 6767, 1952-1 Cum. Bull. 111,120 (R. 421-422).

Statement of the Case.

Petitioner and his three daughters and the family of one Henry Grubel were shareholders in a corporate textile business until December, 1941 (R. 13). Then, in December, 1941, a family partnership[1] was formed between the same stockholders, members of the two families, and it succeeded to the business of the corporation (R. 15).

On June 7, 1942, Grubel, actively associated with petitioner in the business for many years, suddenly died, causing a dissolution of the partnership (R. 16). Petitioner had devoted himself to the supervision of the out-of-town mills which produced the textile fabrics (R. 17, 18, 129). Grubel had been in charge of the New York office, which attended to sales of finished products, checking of customers' credit, pay roll, credit financing of the purchases, collection of accounts receivable and payment of bills (R. 142). Petitioner was ill and on in years (R. 36, 54, 124). Grubel's death required prompt affirmative action (R. 23). Petitioner weighed the possibility of continuing in business and he called upon members of his family (R. 132, 135), [illegible], after discussion, agreed with him to form a New York Limited Partnership (R. 23, 126, 131).[2]

Petitioner did not personally have the money to pay out the family of the deceased (R. 16, 93) and new partners and services (R. 23) were both urgently and speedily required. The capital investment of petitioner's three

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[1] Herein called the 1941 partnership or the Grubel-Weiss partnership.

[2] Herein called the 1942 partnership or the Weiss, Krosney and Sunshine family partnership.

daughters (R. 17, 20) amounting to $131,814.71, which they had acquired from their mother over twenty years prior, and from gifts from petitioner from time to time, not contemporaneous with or incident to the formation of this partnership, as well as from accumulations of earnings on their investments over the years, helped petitioner to pay out the Grubel family (R. 17, 20, 48, 49, 93, 339). His daughters' contribution of mill properties as part of their capital investment, when sold in 1944, accounted for $165,149.84 of the partnership profits (Pl. Ex. 6, Sch. G, Col. 8, R. 333).

Petitioners sons-in-law provided the needed services. Petitioner offered his lawyer son-in-law, Bernard Krosney, a 10 per cent interest (R. 132, 135) in the partnership if he would leave his own profitable manufacturing business (R. 22, 125) and come with him as a general partner, to help manage the business (R. 129). Petitioner also offered his accountant son-in-law, Samuel Sunshine, a five per cent interest in the partnership in order to induce him to remain with him in the management of the business as a general partner (R. 21, 141). Bernard Krosney and Samuel Sunshine each was offered, in addition to their partnership interests in profits or losses, a living expense drawing account of $7,500 per annum. Our country was at war and competent managerial services were at a premium and difficult to get. The new family partnership began on June 8, 1942, and ended in 1944.

Upon the death of Grubel in June, 1942, the books of the 1941 partnership had been closed and the profits up to June 7, 1942 (the date of Grubel's death) had been distributed among the partners. The succeeding 1942 family partnership, pooling the assets of the Weiss, Krosney and Sunshine families, began on June 8, 1942, closed its books at the end of the calendar year on December 31, 1942, and distributed the profits among the partners. Conse-

quently, petitioner had to report for 1942 his share of the profits from two separate and distinct partnerships.

Action of the Commissioner: Internal Revenue Agent Clines, in 1948, examined both the Grubel-Weiss 1941 partnership and the Weiss, Krosney and Sunshine 1942 partnership for the years 1942, 1943 and 1944. He made changes in the distribution of net partnership income among the partners, for both partnerships. None of the partners of the Grubel-Weiss 1941 partnership protested the Commissioner's findings of fact or the changes made in the partnership return of the distribution of net income among the partners as to that 1941 partnership because the additional taxes, which were assessed and duly paid, were considered trifling and Grubel had died. The Commissioner did not assert at any time that there were other taxes due and unpaid arising from that partnership. Petitioner's claim for refund and his complaint were clearly directed at the 1942 partnership and his request for judgment was as to the tax assessed on the revised distribution of that partnership's profits. Though the total of petitioner's 1942 income was in issue, he raised no issue as to that part which he derived from the 1941 partnership. However, there was a question of principle at stake as to the 1942 partnership and whatever money judgment was sought would result from its proper decision (R. 2-6).

Petitioner objected to the reallocation of the partnership income of the 1942 partnership for the years 1942, 1943 and 1944 (R. 342-345). The report of Revenue Agent Clines was made after reviewing the services rendered by all the active general partners, including petitioner, Bernard Krosney, and Samuel Sunshine, and the limited partner, Beatrice Weiss. The report also shows that with respect to the two non-working partners, Helen Sunshine and Miriam Krosney, their capital contribution was sub-

stantial and did not originate as an incident to or contemporaneous with the formation of the partnership (R. 93, 339). Petitioner paid the tax to avoid interest charges, filed his claim for refund and, when the claim for refund was not allowed, commenced suit.

The following table shows the capital contribution of the various partners at the formation of the 1942 partnership, as well as the distribution of profits per the agreement, and as per the reallocation of the Commissioner, and reflects the percentage change made:

General Partners	Capital Invested[3] At the Beginning		Profit Sharing Per Agreement[4]	Per C. I. R.[5]
Philip Weiss	$202,746	59.6%	40%	58%
Samuel Sunshine	3,000	.9	5	2
Bernard Krosney	3,000	.9	10	2
Limited Partners				
Beatrice Weiss	65,957	19.4	20	19
Helen Sunshine	43,957	12.9	15	13
Miriam Krosney	21,900	6.3	10	6
	$340,560[6]	100. %	100%[7]	100%[8]

[3] (R. 398, Ex. O) Cents omitted.

[4] (R. 398, Ex. O) After salaries to Samuel Sunshine and Bernard Krosney of $7,500 each and $20,000 to petitioner.

[5] (R. 379, Ex. I) After increase of salaries to Samuel Sunshine and Bernard Krosney by Commissioner to $15,000 each and disallowance of salary to petitioner.

[6] (R. 338.)

[7] (R. 339.)

[8] (R. 340.)

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Specification of Errors to be Urged.

Petitioner submits that the Court of Appeals erred:

I. By ruling in the instant case, of a concededly bona fide family partnership, where the agreed division of profits was not wholly unreasonable, that the Commissioner had the power to disregard the agreed profit-sharing and salary arrangements of the partners, contrary to the decisions of the Courts of Appeal of other circuits and the Tax Court of the United States.

II. By interpreting Section 7 of Mim. 6767, 1952-1 Cum. Bull. 111,120 (R. 421) so as to make the test not the *"Reasonableness of the Agreed Division of Profits"* for each partner at the formation of the partnership as therein provided, but instead substituting a test of *"return on capital invested,"* looked at retrospectively after the year end.

III. By affirming the judgment of the District Court.[9]

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[9] We reserve the following specifications of error to be urged on appeal in the event this writ of certiorari is granted:

(a) Admission of opinion testimony on the question of "return on invested capital" when such a basis had no bearing on partners' agreement to share profits and losses.

(b) Did the Trial Court commit reversible error in permitting the introduction of Exhibits P, Q and R (R. 404-411)?

(c) Did the Court commit reversible error by making the 1941 partnership an issue in this case?

(d) If decision of this Court in the *Culbertson* case of what was left undecided therein permitted allocation of profits between use of capital and services, then a retrial of this case should have been ordered as in *Gowran v. C. I. R.*, 7 Cir., 87 F. 2d 125, 127, aff'd 302 U. S. 238, 245.

(e) The Court in permitting the jury to reallocate profits between capital and services delegated to it powers which by law only the Commissioner has.

(f) The Courts below were influenced by I. R. C. Sec. 191, added by Sec. 340 (B) of the 1951 Act, without distinguishing between a gift of a partnership interest and where a partnership is based on new capital or services contributed.

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Reasons for Granting the Writ.

A. The undecided question in C. I. R. v. Culbertson, 337 U. S. 733, and conflict of circuits.

This case presents issues concerning a bona fide family partnership requiring a determination by this Court of the question it expressly left undecided in *C. I. R. v. Culbertson,* 337 U. S. 733, at p. 748, and about which the decisions of the various Circuit Courts of Appeal are in conflict.

In the present family partnership case, the very question is presented. The Court below stated, "Here we have to deal not so much with the existence of such a partnership, but with the distribution of its income among its members * * *" (R. 417). The existence of a valid partnership was established by the uncontradicted testimony of a contribution by all of the partners of either needed capital or vital services, or both. The Commissioner of Internal Revenue presented his case as a test of *his power to reallocate partnership profits contrary to the agreement of the partners.* The Courts of Appeal of other circuits have held that the Commissioner does not have the power to disregard agreements of partners (who are in the best position to know their relative worth to the business at the inception of the partnership), and to substitute instead the Commissioner's judgment as to the allocation of profits in after years when a profit and not a loss has been established. *Marcus v. C. I. R.,* 5 Cir., 201 F. 2d 850, 853; *Woosley v. C. I. R.,* 6 Cir., 168 F. 2d 330; *Hartz v. C. I. R.,* 8 Cir., 170 F. 2d 313.

However, as long as there existed a conflict among the various circuits, the Commissioner's claim of power continued respecting the reallocation of income between capital and services in a bona fide partnership, and especially

since the Court below agreed with him regarding the Culbertson statement, at p. 748, as lending support to the language of his own Mim. 6767, 1952-1 Cum. Bull. 111, 120 (R. 421).

An examination of the facts in the present case in the light of this Court's decision in *C. I. R. v. Culbertson,* 337 U. S. 733, and the decision of the other circuits holding that the partners' agreed division of profits is to be respected will indicate that the principle of *Gowran v. C. I. R.,* 7 Cir., 87 F. 2d 125, 127, aff'd *Helvering v. Gowran,* 302 U. S. 238, 245, referred to by the Court below, is inapplicable.

The Sons-in-Law: The Court below noted the fact that "the responsibility of the operations and management rested upon the two general partners Bernard and Samuel" (R. 419). The Commissioner saw fit to increase their salaries from the $7,500 the partners had agreed on, to $15,000 each per annum, thus recognizing the value of the contributions made by their services to the partnership income (R. 340). Bernard and Samuel did not enter into the partnership looking for jobs or salaries. They worked and they risked their credit for the partnership profits. Their agreed partnership interests should not have been disturbed only because their capital contribution was small. It was their services and their good business experience which contributed substantially to the earnings of the new partnership (R. 129, 130, 140). *Greenberger v. C. I. R.,* 7 Cir. 177 F. 2d 990. Under the circumstances, and since it could not be foretold at the formation of the partnership whether there would be profits or losses, can it be said that these minimum drawing accounts of $7,500 per annum and the offer to Bernard Krosney and Samuel Sunshine, respectively, of a 10 per cent and a 5 per cent interest in the profits or losses, were unreasonable? Strangers would have driven a harder bargain at the time.

In order to invoke his alleged power to reallocate profits of a valid partnership among its members, the Commissioner cited as authority Sec. 7 of Mim. 6767, 1952-1 Cum. Bull. 111, 120 (R. 421). The temptation to twist the language by substituting the test of "Return on Capital Invested" in place of "Reasonableness of Agreed Division of Profits" suggested itself to the Commissioner because the return to some of the partners based upon their capital contribution was high. It was this preoccupation with the misleading interpretation of Mim. 6767 which opened the door at the trial to the admission of irrelevant opinion testimony on "a return on invested capital" and in the form of the many exhibits of the Commissioner, more particularly Exhibits P, Q and R (R. 401-411). Thus, statistics were erroneously submitted to the jury reflecting fantastic percentages of return on the purely *token* capital contributions made by Samuel Sunshine and Bernard Krosney, the two valuable business managers who had contributed so much to the profits of the business, as follows:

	1942	*1943*	*1944*
Bernard Krosney	1280.33%	958.59%	1061.20%
Samuel Sunshine	640.15%	479.29%	530.60%

Exhibit P (R. 402-404), in which the above percentages were shown, was admitted on the theory that the apparently exorbitant percentages reflected a donative deflection of income on the part of petitioner to his sons-in-law and family. The effect was to deprive Samual Sunshine of 3 per cent, and Bernard Krosney of 8 per cent, of the profits, and add the total of 11 per cent to petitioner's taxable share of the partnership profits. This reallocation ignored the fact that Krosney and Sunshine had helped create the very income which they shared and presupposed that petitioner had made but a futile

gift. Supposing they had contributed no capital at all, how could the percentages of profits then be related to capital investments? In their case, their services alone sufficed to make them valuable partners. *C. I. R. v. Culbertson*, 337 U. S. 733.

Miriam and Helen: The decision of the Court below states (R. 418): "The issue centers particularly about the shares of partnership income allocated to the daughters Miriam and Helen, who contributed only capital, not services, and appeared to be receiving *an unusual return on their capital investment.*" In so stating the Court below erroneously gave undue weight to the fact that Miriam and Helen contributed only capital because this Court in *C. I. R. v. Culbertson, supra*, clearly stated that a contribution of either capital or services was sufficient to support a valid partnership.

The Courts below were in error in approving the introduction of Exhibit Q (R. 405-409), which allowed Miriam Krosney and Helen Sunshine a 10 per cent return (which figure was culled from thin air) for the use of their capital and in allocating the remainder to petitioner. *Dorzback v. Collison*, 3 Cir., 195 F. 2d 69 (1952); *Forman v. C. I. R.*, 9 Cir., 199 F. 2d 881 (1952).

Helen and Miriam alone brought $65,857 into the business, or 19.2 per cent of the total capital, a very substantial part of the capital which was desperately needed. The partners agreed that Miriam and Helen were to receive 15 per cent and 10 per cent respectively, or a total of 25 per cent share in the profits or losses. Considering that the business was the manufacturing of textiles for the ladies' apparel industry, a notoriously speculative business; considering that an experienced and valuable partner had just died and had to be replaced; that the remaining senior partner was ill and felt he was getting

on in years; the hurried action required to preserve the continuation of the business; and all these factors together, it is clear that the shares in the profits or losses given when the partnership was formed to these two, Helen and Miriam, were not unreasonable. The difference between their capital contribution and their agreed share was but 5.8 per cent. Strangers might have driven a harder bargain. The fact is that the Commissioner took $32,660 from the shares of profit of these two for the years 1943 and 1944. Yet the mill properties alone (aside from cash) which Miriam and Helen, together with their sister, Beatrice, contributed to the partnership, brought $165,149 (R. 271) of profits when the mills were sold in 1944 (Pl. Ex. 6, Sch. G, col. 8, R. 333), and the petitioner benefited by receiving his 40% partnership share.

The Court below described the changes made by the Commissioner in the shares of the two sons-in-law as "slight" (R. 419). The changes for them totaled 11 per cent. It logically follows that the changes made, reducing the percentages of Miriam and Helen by a total of only 6 per cent (Miriam 4 per cent and Helen 2 per cent), were less than "slight." And since, according to Sec. 7 of Mim. 6767, 1952-1 Cum. Bull. 111, 120 (R. 421), only "A *wholly* unreasonable agreement as to the sharing of partnership income *may* be evidence of the absence of bona fide partnership intent * * *," it follows that an agreement among partners as to the sharing of profits or losses reflecting so small a difference from what the Commissioner seeks to establish as to amount to less than "slight," should not be disturbed.

Beatrice: The Court below comments that "Although Beatrice gave her full time to the business she * * * was paid no salary" (R. 419). Beatrice's timely investment of needed capital was 19.4 per cent of the total capital of the business. The Commissioner considered capital to be the important factor (R. 419). In view of this capi-

tal contribution and her full time devoted to important managerial functions without pay, surely the partners' agreement to allow her an additional 6/10ths of 1 per cent, making her partnership interest in the profits or losses 20 per cent, was not unreasonable. Without question, a stranger might have driven a harder bargain.

In the present case, the agreement for the division of profits was made between the partners after they had thoroughly debated the equities and bargained at arms length. The business purpose is unquestionable. Each partner contributed something vitally needed and gave up something of great value. Petitioner, Krosney and Sunshine were all married and each family group depended on its respective shares of the profits for their existence. The great good fortune of the three families working together as partners is aptly described in *Ardolina v. C. I. R.*, 186 F. 2d 176, at p. 182, where the Court said:

> "* * * All of the evidence compels the conclusion that the Ardolinas' * * * entire married lives down to the particular time in question naturally and honestly led up to the formation of their * * * partnership. The evidence leaves no doubt of their good faith in entering into that arrangement. *The astounding success of the partnership, under the family regime does much to justify the avowed business purpose of the partnership,* namely by the Ardolinas' joint present conduct of the enterprise to insure its sound operation * * *."

The Court below relied on its own decision in *Sommers v. C. I. R.*, 2 Cir., 193 F. 2d 609, Reh. 195 F. 2d 680, where it "inferentially recognized" (R. 421) the taxing authority to have the power of reallocation of profits. But the facts in *Sommers v. C. I. R., supra,* were different because there a sub-venture existed between husband and wife.

Furthermore, the question involved in *Sommers v. C. I. R., supra,* and the present case were also involved in the cases decided contrariwise by the Courts of Appeal in other circuits, and hence there is a direct conflict of opinion. We believe that the weight of law is with the other circuits.

In *Marcus v. C. I. R.,* 5 Cir., 201 F. 2d 850, at p. 853, the Court said:

> "Particularly is it true that it was not for the commissioner and the Judge to substitute their ideas for what the partners ought, in creating the partnership, to have provided in respect to sharing its profits. This, as the Supreme Court, in the *Culbertson* case, and we, in later cases, have pointed out, was for the determination of the partners if made by them in good faith, that is as a reality and not as a sham."

In *Woosley v. C. I. R.,* 6 Cir., 168 F. 2d 330, the Court at pp. 332-333 held:

> "The partnership agreement did not provide, as the tax tribunal inferred, that the profits of the partnership were to be divided *in proportion to the capital contributions of the partners.* The sharing of profits and losses, according to the express provision of the agreement of May 26, 1937, which was continued and confirmed by the last agreement of December 30, 1939, *was to be in proportion to the interest of each of the partners in the partnership.* * * * It is obvious that the parties did not contemplate compensating themselves in full by the payment of salaries, but that *each expected to receive, in addition to his or her salary, the specified division of profits.*"

In *Hartz v. C. I. R.,* 8 Cir., 170 F. 2d 313, at p. 318, the Court stated:

> "* * * From these cases and the many other reported cases on the subject we understand the rule

> to be that if the facts disclose a real bona fide partnership, it may not be disregarded for tax purposes. * * * Our difference arises from a failure by the Tax Court to find and give due deference to the uncontroverted evidence that this partnership was created in good faith for the purpose of obtaining necessary working capital to insure the continued existence of the business. We find no justification for a conclusion that this was a sham or a device to avoid the payment of taxes. Concluding, as we have, that this record compels the conclusion that this was a valid partnership, the Tax Court had no right to reapportion the income of the partnership between the partners for tax purposes."

Other cases holding the Commissioner may not substitute his judgment for the parties' where the agreement is valid, are *Canfield v. C. I. R.*, 6 Cir., 168 F. 2d 907, 913; *Delchamps v. C. I. R.*, 13 Tax Court 281, 287. See: Taxes, Vol. 25, Number 11, pp. 963, 970 (Nov., 1947).

In *Dorzback v. Collison*, 3 Cir., 195 F. 2d 69 (1952), a wife loaned $8,500 to her husband's business on a promissory note bearing interest at 5%. Two years later, they agreed that if she accepted in place of her note a different sort of bond, which subordinated her claim to the claims of other creditors, the business would pay her in lieu of interest a sum equal to 25% of the business profits after a salary to the husband of $4,000 per annum. The Commissioner disallowed this deduction of 25% of the profits to the husband because, he said, as an interest payment it was larger in amount of dollars than the debt itself and it was so unreasonable as to be tantamount to a subterfuge for the reallocation of business profits. The debt to the wife was not denied. The Court, at page 72, said:

> "Throughout the ages lenders have exacted all they could from borrowers for the use of money.

> How much has been exacted has depended on the desperation of the borrower and the exigency of the moment. There is no requirement in Section 23 (b) that deductible interest be ordinary and necessary or even that it be reasonable. * * *"

To the same effect, see *Forman v. C. I. R.*, 9 Cir., 199 F. 2d 881.

B. The novel, irrelevant and impracticable test of "Return on Capital Investment" as an element in partnership agreements, if approved by this court may well become a form of judicial legislation.

Interference by the Commissioner or by the Courts with contracts made in good faith should not be encouraged. In the language of Mim. 6767, 1952-1 Cum. Bull. 111,120 (R. 421), the Commissioner made "Reasonableness of Agreed Division of Profits" a test of bona fide partnership intent. Where such contracts are "wholly unreasonable," we can follow the reasoning which declares the partnership invalid. A partnership which is "partially invalid" (R. 422) so as to reject as partners some of the members because of some test approved in the reasoning of this Court's decision in *C. I. R. v. Culbertson*, 337 U. S. 733, is also understandable. If a valid partnership exists, but the partners' agreed division of profits does not coincide with the Commissioner's ideas (R. 417), then the Commissioner should not be permitted, by substituting the test of *Reasonableness of Return on Capital Invested*, to twist the plain meaning of his own Mim. 6767, 1952-1 Cum. Bull. 111,120, which, in providing a test of bona fides, reads, in part:

> "7. Reasonableness of Agreed Division of Profits —Allocation. A *wholly* unreasonable agreement as

> to the sharing of partnership income may be evidence of the absence of bona fide partnership intent * * *."

In the first place, prospective partners do not generally have the gift of prophecy and, hence, cannot foresee whether the business will result in either a profit or a loss. It also follows that they do not agree when they join together in a business venture, to be paid "a return on invested capital," since there may be no profits at all, and possibly no capital left either. How would the Court below have reconciled its decision in *Sommers v. C. I. R.*, 2 Cir., 193 F. 2d 609, Reh. 195 F. 2d 680, if the partnership had sustained a loss for the year in question?[10] Therefore, when Internal Revenue Bulletin Mim. 6767 speaks of "Reasonableness of Agreed Division of Profits" or sharing of partnership income, it does not mean *Reasonableness of Return on Invested Capital.* The test is as to the agreed division of profits or losses, spoken of at the formation of the partnership, and not after the year end or years later upon the Commissioner's examination of the income tax returns and the profitable results are an established fact.

The Court below refers to a donative scheme or deflection of income by petitioner, which is negatived by the fact that petitioner had only a 30% interest in the profits of the 1941 Grubel partnership, together with a salary of $12,000 per annum as compared with a 40%

[10] "The Allocation Theory in Family Partnership Cases," appearing in the November, 1947, issue of "Taxes," Vol. 25, Number 11,963 at page 969, in discussing *Canfield v. C. I. R.*, 6 Cir., 168 Fed. 907, raises the question that if $7,500 of the profits were attributable to Mr. Canfield's personal services and if, instead of a gain, there had been a loss, would the Court have held that the value of his services were a minus $7,500.

interest in the instant partnership, together with a salary of $20,000 per annum (R. 19). Furthermore, had this partnership been an artificial creation at the whim of petitioner, the capital contributions might well have been adjusted at the beginning so as to conform with the shares in the profits which each partner was to enjoy.

The Revenue Acts[11] provide for the keeping of records reflecting the business gross income and deductions. The instant partnership kept the records provided by law and the facts disclosed were verified correct by Internal Revenue Agent Clines.

C. Allocation of profits between capital and services.

At the trial below, the Commissioner attempted to find factual evidence to support his proposed reallocation of partnership income between capital and services, by opinion testimony exacted from petitioner under protest (R. 54, 55, 56, 57, 60, 61, 62). Petitioner was not prepared, nor did he believe it was possible, to voice fair or reliable opinion as to what portion of the profits was attributable to capital and what to services. Nor was the Commissioner aided by the alleged expert testimony of Internal Revenue Agent Clines, who discredited his own testimony by stating that he had merely followed Bureau policy and had prepared the offered exhibits as instructed, to serve as mathematical calculations (R. 267); that they did not represent his opinion because in the seventeen years that he had been in the Internal Revenue Service, during which time he had examined about ten partnerships each year, he had never seen a partnership agreement provide for return on invested capital rather than a percentage division of the profits (R. 180, 256).

[11] Int. Rev. Code Secs. 181-183, 26 U. S. C. A. Secs. 181-183.

Petitioner cannot agree that it is practicable or possible to allocate correctly in advance the profits of his business between the value of the services of the partners and their invested capital, bearing in mind the many other contributing causes to the ultimate profits of his business—or, for that matter, in the case of any other manufacturing business. It is difficult to foresee at the formation of a partnership the extent to which each partner's services actually will contribute to the partnership earnings.[12]

In the present case, it is especially fruitless to speculate about the allocation of profits because on the very face of things, when we examine the partners' agreement for the percentages which they agreed upon among themselves and compare them with what the Commissioner allowed, it becomes apparent that no such *wholly unreasonable division* appears as would justify meddling with the partners' agreement.

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[12] The fixing of salary accounts is a matter of bargaining. The business net profits are the result of effort on the part of management and many employees on a salary basis and salespeople on a commission basis. Business profits may result from fortunate purchases, from an extraordinary state of the times (like a war period), or from an exclusive agency to represent the producers of a branded or special product, like a formula or patented item which gives the business a legal monopoly. And no matter how many other situations which one can think of and describe, there are still other explanations possible of how the profits of a business could happen beyond the efforts of the partners and beyond the invested capital. It is therefore useless and unprofitable to pursue the attempt to separate business profits into the contributing sources at the inception of the partnership, when none can foresee what events will favor capital and which circumstances will cause one partner to produce more profits than another. In the final analysis the partners must decide after bargaining with each other.

D. The questions in this case are of nation-wide interest.

The questions herein presented are involved in numerous cases now pending before the Internal Revenue Service and the Courts. Neither the Revenue Acts of 1948 and 1951, nor *Commissioner v. Culbertson*, 337 U. S. 733, settled all the vexing questions arising in family partnerships. By the 1948 Law, married taxpayers computed their taxes by dividing their income in half, computing the tax according to the rate applicable to the halved income, and then doubling it to reach the tax payable. This settled the tax dispute in husband and wife partnerships. However, there still remain partnerships between ancestors and descendants and brothers and sisters, etc. The 1951 Revenue Act does not settle their difficulties.[13] There are cases as between ancestors and descendants where the capital contributed by the donee or vendee partner was not received as a gift incident to or contemporaneous with the formation of the partnership. And brothers and sisters, and brothers and sisters-in-law, or sons and daughters-in-law, do not fall within the definitions expressly stated in the Act (family includes only spouse, ancestors and lineal descendants).

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[13] The Court below in its footnote (R. 422) indulges in reflections concerning the effect of the 1951 Revenue Act (I. R. C. Sec. 191 added by Sec. 340 [b] of the 1951 Revenue Act). Apart from the irrelevance of this observation, it is incorrect. The very purpose of the act was not to look to the source of the gift but rather its reality. The gifts in the present case were not made incident to or contemporaneous with the formation of the instant partnership (R. 339) and not all of the daughters' capital contributions originated as gifts from petitioner (R. 48). Even if it were applicable, the 1942 partnership agreement provided for a salary to petitioner of $20,000 before a division of profits consonant with this statutory enactment which the Commissioner ignored. See example in Vol. 3, C. C. H., 1953 Fed. Tax Rep., Par. 1186F, p. 16136.

CONCLUSION.

For the foregoing reasons, we respectfully submit that this petition should be granted.

November, 1953.

MORLEY S. WOLFE,
SAMUEL KALMANASH,
Counsel for Petitioner.

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In the Supreme Court of the United States

OCTOBER TERM, 1953

No. 455

PHILIP WEISS, PETITIONER

v.

JAMES W. JOHNSON, COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The District Court wrote no opinion. The opinion of the Court of Appeals for the Second Circuit (R. 417-423) is reported at 206 F. 2d 350.

JURISDICTION

The judgment of the Court of Appeals (R. 423-424) was entered August 19, 1953. The petition for a writ of certiorari was filed November 3, 1953. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the courts below erred in sustaining the jury's finding that a division of the profits of a family partnership was not a *bona fide* and reasonable one as related to the services and capital contributed by the respective partners, and that a portion of the profits allocated to two of the taxpayer's daughters was derived from taxpayer's capital and therefore includible in his gross income as defined in Section 22(a) of the Internal Revenue Code.

STATUTE INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) [As amended by Sec. 1, Public Salary Tax Act of 1939, c. 59, 53 Stat. 574] *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business

carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U.S.C. 1946 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

(26 U.S.C. 1946 ed., Sec. 182.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated

organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * *

(26 U.S.C. 1946 ed., Sec. 3797.)

STATEMENT

This action was brought in the District Court for the Southern District of New York by Philip Weiss (the taxpayer) against James W. Johnson, Collector of Internal Revenue, for what was then known as the Third Collection District of New York, for recovery of amounts aggregating $82,916.27, alleged to have been erroneously collected from him as federal income taxes and interest for the years 1943 and 1944. (R. 2-6.) The case was tried to a jury (R. 1), which rendered a verdict for the Collector and denied recovery (R. 317). Judgment on the verdict was entered for the Collector, with costs (R. 412), and taxpayer appealed (R. 413). The judgment was affirmed by the Court of Appeals. (R. 423-424.)

The issues presented to the jury by the instructions of the trial court (R. 297-313) were (1) whether the taxpayer had borne the burden of proving that he had in fact overpaid his income tax for the years at issue as alleged, (2) whether the taxpayer had proved the *bona fides* of an alleged part-

nership purportedly formed in June, 1942, composed of himself and members of his immediate family, and also the *bona fides* of a prior purported partnership entered into on December 1, 1941, by the taxpayer and his three daughters, together with one Henry Grubel and his daughter (individually and as trustee), to conduct a business which theretofore had been conducted by a corporation all of the stock of which was owned by those entering into the 1941 partnership, and (3) if these partnerships were *bona fide,* whether the agreed division of profits among the several partners was a reasonable and *bona fide* one.

The evidentiary facts are set forth in the opinion of the Court of Appeals. (R. 417-423.) Briefly, the taxpayer was engaged in the textile manufacturing business from 1929 to 1941 with Henry Grubel in a corporation named Plaza Mills, Inc., owned by them and their families. The corporation was dissolved on December 1, 1941, and a limited partnership of the former stockholders was formed to operate the business. The taxpayer and Grubel were general partners, with Grubel's daughter, Irene (individually and as trustee), and the taxpayer's three daughters, Miriam, Helen, and Beatrice, as limited partners. This partnership was dissolved as of June 7, 1942, upon the death of Henry Grubel; a new limited partnership was formed of the Weiss family only, who bought out the Grubel interests. The general partners were the taxpayer; his son-in-law, Bernard Krosney (husband of Miriam); and his son-in-law, Samuel Sunshine (hus-

band of Helen). The limited partners were the three daughters, Miriam, Helen, and Beatrice. This partnership operated the business until it was sold in 1944. (R. 418.)

The certificate of the limited 1942 partnership purported to state the contributions of the limited partnership thus: Miriam, $21,900; Helen, $43,-957.36; Beatrice, $65,957.35; and the share of profits each was to receive by virtue of her contribution was: Miriam 10%; Helen 15%; Beatrice 20%. The remainder of the partnership agreement was oral. The total capital contribution of the partners as computed by Revenue Agent Clines, who recommended assessment of the additional tax which is the subject of the present suit, was $340,561.34, of which the taxpayer's interest acquired on dissolution of the prior partnership was $202,746.63, while Bernard and Samuel each contributed $3,000, and the daughters contributed the amounts set out above. (R. 418.)

Taxpayer was receiving a salary of $20,000 a year, while Bernard and Samuel each was receiving $7,500. Although Beatrice gave her full time to the business, she was only 22 and in 1942 was paid no salary. After the above stated percentages of profits to the daughters (totaling 45%), the remaining 55% was divided 40% to the taxpayer, 10% to Bernard, and 5% to Samuel. (R. 419.)

Revenue Agent Clines testified that the active conduct of the business was by Bernard, Samuel, and Beatrice, the taxpayer acting only in an advisory capacity, because he desired to retire for age

and illness. Since Revenue Agent Clines considered capital to be the important factor, he adjusted the limited partners' distribution of profits to conform with their proportionate share of the total capital invested in the business. And as the responsibility of the operation and management rested upon the two general partners, Bernard and Samuel, he proposed a salary to each of $15,000 a year, plus 2% of the profits after salary (instead of the approximately 1% each contributed to the invested capital). Hence, his revised distribution of profits was (after deduction of salaries of $30,000 a year) as follows: the taxpayer, 58%;[1] Bernard, 2%; Samuel, 2%; Miriam, 6%; Helen 13%; Beatrice, 19%. Except for the slight variation in the percentages to Bernard and Samuel, these percentages corresponded closely to the partners' percentage contributions to invested capital. (R. 419.)

This recommendation was adopted by the Commissioner and applied to net income of $326,633.34 for 1943, and $176,680.74 for 1944. The total amount of additional taxes for the two years assessed against the taxpayer, with interest, was $82,916.27, while the total overassessment in favor of the other members of his family was about $53,000, which, with their consent, was applied against the assessment against the taxpayer. He paid the balance. Although he originally sued for the full amount assessed against him, he reduced his claim at the

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[1] As noted above, taxpayer's percentage share was 40% under the division previously made by the partnership.

trial to the amount he had actually paid in cash, namely, $29,774.99. (R. 419.)

ARGUMENT

1. In affirming the District Court and refusing to disturb the jury's verdict, the court below did not depart from the reasoning of this Court in *Commissioner* v. *Culbertson,* 337 U.S. 733; *Commissioner* v. *Tower,* 327 U.S. 280; and *Lusthaus* v. *Commissioner,* 327 U.S. 293. In the *Culbertson* case, the Court, reaffirming its holdings in *Tower* and *Lusthaus,* held that whether a family partnership is entitled to recognition for federal income tax purposes depends upon whether (p. 742) "considering all the facts * * * the parties in good faith and acting with a business purpose intended to join together" as partners. This question, said the Court (p. 743), is one of ultimate fact for the trial tribunal, no single factor being conclusive. Reversing the decision of the Court of Appeals, which had overturned that of the Tax Court, it remanded the case to the Tax Court for a determination of whether the parties had (p. 748) a "bona fide intent" to be partners, either because of services or because of contributions of capital of which they were the true owners. In remanding the case, the Court stated (p. 748) that "No question as to the allocation of income between capital and services is presented in this case," and it accordingly refrained from expressing any opinion on that question.

While there was no occasion in *Culbertson* to pass upon the allocation question, the court below cor-

rectly observed (R. 421-422) that the fundamental principles there applied, in determining whether the parties to a family partnership agreement are entitled to recognition as partners for tax purposes, also apply with full force where the partners are entitled to recognition as such, but agree upon a division of the profits which is patently disproportionate to their respective contributions of capital and services, or is otherwise not *bona fide*. A deflection of the income of a family partnership from one partner to another is no more tolerable under the principles of the *Culbertson* line of cases than the deflection of the income of a sole proprietorship to a claimed partner. That members of a taxpayer's family are his partners by virtue of a contribution of *some* capital or services does not preclude an inquiry by the taxing authority into whether the shares of the total business income reported by them in their tax returns have been fixed in good faith and bear a reasonable relationship to their respective contributions. We know of no case challenging this principle. The very cases relied upon by taxpayer for conflict (Pet. 8, 14-15) recognize the authority of the Commissioner to challenge the *bona fides* and reasonableness of the agreed division of income.

Moreover, the general principle was properly applied here. The Commissioner determined that taxpayer and two of his daughters, who contributed only capital and no services, were ascribed portions of the earnings of the family partnership which bore no reasonable relationship to

their contributions. After paying the resulting deficiency in income tax, taxpayer sued for a refund. The case was tried before a jury, and extensive testimony was taken in a four-day trial. The District Court correctly instructed the jury (R. 420) that in order to obtain a refund taxpayer had the burden of showing that a *bona fide* partnership existed and also that the agreed division of profits "was a bona fide and reasonable one, taking into account all the facts and circumstances." The jury found against the taxpayer, and a summary of the evidence recited by the court below shows (R. 418-420), as the court held (R. 420), that "there was ample evidence to support the jury's verdict." Under the circumstances, the District Court properly refused to set aside the verdict, and the court below correctly affirmed its decision.

2. Each case in this field turns as it must on its own facts, and the cases with which taxpayer asserts conflict (Pet. 8, 14-16) are readily distinguishable on their facts. In each of them the court of appeals reversed the Tax Court's finding that the agreed allocation of the profits was unreasonable, on the ground that the finding was clearly erroneous in the light of all the evidence. In each instance, however, the appellate court properly acknowledged that such a finding was a permissible one if supported by the record. Thus in *Woosley* v. *Commissioner* 168 F. 2d 330 (C. A. 6th), the court was careful to point out (p. 333) that "Situations may be presented in which the Tax Court might properly make allocations of income in husband and

wife partnership cases; but, on its facts, this case is not one of that kind." See also *Canfield* v. *Commissioner,* 168 F. 2d 907, 913 (C. A. 6th). Again, in *Hartz* v. *Commissioner,* 170 F. 2d 313 (C.A. 8th) certiorari denied, 337 U.S. 959, the court also took pains to point out that in reversing the Tax Court (p. 318) "we do not mean to say that a division of income between alleged partners must necessarily be adhered to for tax purposes merely because it is written into an alleged partnership agreement," and that "If such a division is artificial" it could be disregarded by the Commissioner and the Tax Court. In *Marcus* v. *Commissioner,* 201 F. 2d 850 (C.A. 5th), no question of allocation was presented, but the court stated (p. 853) that under the *Culbertson* decision an allocation agreed upon by the parties was binding "if made by them in good faith, that is as a reality and not as a sham." *Dorzback* v. *Collison,* 195 F. 2d 69 (C.A. 3d), with which taxpayer also asserts conflict (Pet. 15-16), did not involve a family partnership; the question presented was the deductibility of interest paid by the borrower-husband to the lender-wife. Cf. *Sommers* v. *Commissioner,* 193 F. 2d 609, rehearing denied, 195 F. 2d 680 (C.A. 2d), which is in accord with the decision below (see R. 421-2).

In this case, not only is there "ample evidence" to support the jury's verdict that the agreed division of the profits was not a *bona fide* and reasonable one (R. 420), but also, since the case was tried before a jury, the scope of appellate review is more limited than in the cases relied upon by taxpayer,

where the facts were found by the Tax Court. What is more, since this is a suit for refund of taxes alleged to have been erroneously collected, taxpayer was under a heavier burden of proof than in cases where a taxpayer seeks a Tax Court review of a deficiency determination. *Lewis* v. *Reynolds,* 284 U.S. 281; *Stone* v. *White,* 301 U.S. 532.

3. Even assuming that a conflict does exist, recent legislation has rendered it academic with respect to taxable years after 1950. Section 191 of the Internal Revenue Code, added by Section 340(b) of the Revenue Act of 1951, c. 521, 65 Stat. 452, provides that the distributive share of a donee (or vendee) member of a family partnership is nevertheless to be taxed to the donor partner to the extent that the share is determined without first deducting reasonable compensation for the donor's services, or to the extent that it is disproportionate to the donee's capital contribution.[2] Moreover, while Section 340(c) of the 1951 Act makes this new section applicable to taxable years after 1950, it also provides that determinations for prior years shall be made "without inferences drawn from the fact that this section is not expressly made applicable" to prior years. See also Mim. 6767, 1952-1 Cum. Bull. 111.

4. Contrary to taxpayer's assertion (Pet. 20),

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[2] As the court below noted in a footnote to its opinion (R. 422), much of the daughters' contributions came to them by gift from taxpayer, and had the taxable year here involved been 1951 or a later year this new provision would have explicitly authorized reallocation of the partnership income.

this case does not present issues of general importance meriting this Court's attention. As just indicated, recent legislation has largely disposed of the allocation problem in family partnership cases, at least with respect to taxable years after 1950. With respect to prior years, the guiding principles have already been laid down by the Court in the *Tower, Lusthaus* and *Culbertson* cases, and each case necessarily turns on its own facts. As for the additional questions which taxpayer alleges are involved (Pet. 2-3), they are merely incidental to the allocation question and the answers likewise depend upon the particular facts of this case. The jury having determined the issues against the taxpayer, and both lower courts having concurred in sustaining the jury's verdict, the case presents no occasion for issuance of the writ.

CONCLUSION

The decision below is correct, and the case does not call for further review. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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DECEMBER, 1953.

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HAROLD B. WILL

IN THE

Supreme Court of the United States

OCTOBER TERM, 1953

No. 455

PHILIP WEISS,

Petitioner,

against

JAMES W. JOHNSON, Collector of Internal Revenue.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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IN THE

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No. 455

PHILIP WEISS,

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JAMES W. JOHNSON, Collector of Internal Revenue.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR THE PETITIONER

Respondent, in his brief, seeks to avoid the issue of law presented in this case by ignoring it. The Commissioner of Internal Revenue, without any legislative enactment, has seized the power to reallocate the profits of a bona fide partnership between capital and services. He now seeks the confirmation thereof by this Court. He does so, in effect, by requesting this Court to deny petitioner's application for a writ of certiorari. By such denial, this Court would, without any consideration of the question grant him such power by judicial legislation, for this Court left unanswered the precise question at the close of *Commissioner* v. *Culbertson,* 337 U. S. 733, where, at p. 748, this Court stated:

> "No question as to the allocation of income between capital and services is presented in this case and we intimate no opinion on that subject."

On audit of the partnership return in 1948, prior to the *Culbertson* decision, the Commissioner asserted his claimed power to change the agreement of the partners in this bona fide partnership by making capital the sole criterion and reallocated the profits approximately according to the precentage of capital contribution of the partners (R. 340). The *Culbertson* decision having intervened before the trial of the case below, the Commissioner, by the opinion evidence and exhibits which he presented, calculated to bring before this Court for review the very question referred to above and left unanswered by this Court. Now, having been successful below, respondent disregards the issue of the Commissioner's power by framing the "Question Presented" (Resp. 2) as (a) Was the division of profits bona fide and reasonable; and (b) Whether the profits allocated to Miriam and Helen were derived from petitioner's capital?

By so framing the question presented, respondent seeks denial of petitioner's application for a writ, on the ground that this Court should not review the evidence. *The distinction that respondent overlooks is, that the opinion testimony and exhibits complained of (Ex. P, Q, R; R. 402-411), admitted in evidence, were irrelevant and posed the wrong question to the jury, namely, "reasonableness of return on capital invested", instead of "reasonableness of the agreed division of profits."*

Our petition refers in detail to the immaterial and irrelevant hindsight exhibits submitted for consideration of the jury, such as Exhibit P (R. 402-404), in which the percentage return on capital invested was substituted as the test of the reasonableness of the division of profits. If only on hindsight, after the taxable years in question

were closed and the returns filed and the parties' success measured, could the percentage of return on capital invested be determined, then how can partners, in making an agreement at the inception of the partnership, be imposed upon by law to use the end result as the basis for their agreement? If the test will be the reasonableness of the return on capital invested rather than the reasonableness of the division of profits, then the parties will be penalized for the success of their endeavors. If this partnership had only earned $35,000.00, which would have been only sufficient to pay petitioner's salary and that of Bernard and Samuel, Exhibit P (R. 402-404) would be meaningless.

There is no doubt, as stated in *Hartz* v. *C. I. R.*, 8 Cir., 170 F. 2d 313, and other cases, that if a division of profits is artificial and unwarranted for want of good faith or absence of proper reasons therefor, then that fact might constitute sufficient ground for a finding that the alleged partnership was a sham or a device to avoid the payment of taxes. *But does the Commissioner of Internal Revenue have the power to rewrite the partners' agreement as to the division of profits where there is no "wholly unreasonable agreement as to the sharing of partnership income"?* The question is not unlike the situation in which a court of equity may step in because of an unconscionable advantage taken by one party to a contract. But before the court would move, it would have to be convinced that there had been such a gross inequity done as to shock the conscience of the court. What have we here? The changes made by the Commissioner of Internal Revenue were "slight" (Resp. 7) in each partner's agreed share of the partnership profits; we urge so slight, as on its face to raise a restraining hand against the Commissioner's interference. Adding the changes made by the Commissioner in the shares of all five of petitioner's partners, the result was a total of only 18%. So completely ridiculous is the position of the Commissioner on his claim of a "patently disproportionate" division of

the profits that his change of only 1% respecting the limited partner, Beatrice (who invested capital and rendered services unpaid for) is completely glossed over! It is petitioner's position that an unwarranted change in the division of profits of even only one of the partners requires reversal of the judgment. It is for this reason, no doubt, that respondent carefully avoids the issue of the irrelevant testimony admitted on the trial, of "return on capital invested" and Exhibits P, Q and R (R. 402-411). If respondent could succeed in spelling out so gross and unconscionable a contract of partnership so as to warrant a finding of bad faith, then the crucial question, "Has the Commissioner the power to reallocate?", would answer itself by the disallowance of the partnership itself.

A. *Conflict of Circuits.* If the court below had not interpreted its decision in *Sommers* v. *C. I. R.*, 193 F. 2d 609, Reh. 195 F. 2d 680 (which involved a sub-venture agreement and not a family partnership case and which conflicts with other circuits,[1]) as being authority that it had previously inferentially decided that the Commissioner did have the power to reallocate partnership income then, perhaps, the court below would have excluded the highly prejudicial and inflammatory Exhibits P, Q and R (R. 402-411) which were prepared by respondent on that issue.

The Court below overlooked the import of the statement by this Court in *Commissioner* v. *Culbertson*, 337 U. S. 733, where at p. 744 it stated:

> "* * * If upon a consideration of all of the facts it is found that the partners joined together in good faith to conduct a business, having agreed that the service or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient."

[1] *Dorzback* v. *Collison*, 3 Cir., 195 F. 2d 69; *Forman* v. *C. I. R.*, 9 Cir., 199 F. 2d 881.

The cases cited by respondent (with two exceptions[2] not material to the family partnership question) are the cases which petitioner relies on to indicate the conflict of the various circuits.

With respect to the latter half of the "Question Presented" by respondent (Resp. 2), the case of *Levin* v. *C. I. R.*, 2 Cir., 199 F. 2d 692 (11/12/52), indicates the intramural conflict within the very court below for, if applied to the facts in this case as to the limited partners Helen and Miriam who had contributed needed capital, the conflicting reasoning in *Sommers* v. *C. I. R., supra,* would not have applied and Exhibit "Q" (R. 406-409) would have been inadmissible.

No citation is indicated by respondent to support the allowance to Helen and Miriam of a "return of 10% on their capital" (Def. Ex. Q; R. 405-408). Although petitioner's capital contribution was larger than their's, the profit on the sale of the mills (which they had contributed) in 1944 (Pl. Ex. 6, Sch. G, Col. 8; R. 333) and the benefit to petitioner in receiving his 40% partnership share, is the best proof of the value to the partnership of the capital contribution by the children.

Respondent inferentially recognizes the conflict (Resp. 12) and then dismisses the importance thereof for the alleged reason that the enactment of Section 191 of the Internal Revenue Code[3] provides that the donor member of a family partnership be first compensated for his services before distribution to the donees. This argument ignores:

1. Petitioner's sons-in-law, BERNARD KROSNEY and SAMUEL SUNSHINE, were not recipients of any gifts from

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[2] *Lewis* v. *Reynolds,* 284 U. S. 281; *Stone* v. *White,* 301 U. S. 532.

[3] Added by Sec. 340 (b) of the Revenue Act of 1951.

petitioner to enable them to make capital contributions to the partnership.

2. A contribution of capital by these two active and very able general partners was not necessary to substantiate their distributive share of the profits.

3. The agreement of the partners, disregarded by the Commissioner, provided for a salary of $20,000.00 per annum to petitioner, which was disallowed upon audit when capital was the sole criterion in the Commissioner's theory of attack upon this partnership.

4. The 1951 enactment permits only the donor's compensation to be fixed or increased by the Commissioner. No citation is furnished by respondent for doubling the salaries of BERNARD KROSNEY and SAMUEL SUNSHINE from $7,500.00 to $15,000.00 per annum and more than doubling their share of the profits from 9/10 of 1% to 2% if the Commissioner was consistent and used capital as the criterion for division of profits. Revenue Agent CLINES recognized the absence of legal authority for this when he testified as plaintiff's (petitioner herein) witness, at page 198 of the Transcript of Record, as follows:

> "Q. Do you know of any law that gave you the right to give a man a higher salary than has been designated for him? A. No.
>
> Q. There is no law to that effect? A. No."

The Revenue Agent then goes on to say that he "tried to give * * * what I thought was a fair salary." The Assistant Federal Attorney then cross-examined at this point (p. 200-201), as follows:

> "Q. Whether or not there is such a law, increasing the value of the services of Mr. Krosney and Mr. Sunshine, you are acting in accordance with the rulings of the Internal Revenue Bureau? A. Yes."

5. The capital contributions of Helen, Miriam and Beatrice were not all gifts from petitioner, and that part which was received as gifts was not contemporaneous with or incident to the formation of the partnership.

B. *Lack of Legislative Authority for the Assumed Power of the Commissioner.* The only authorities cited by respondent in his brief are Sections 22, 181, 182, 191 and 3797 of the Internal Revenue Code. Not one of these citations grants the Commissioner the power to rewrite the agreement between the parties and, in fact, this Court stated in *Commissioner* v. *Culbertson,* 337 U. S. 733, that its decision is not to be inferred to grant him that power. The only reason apparently for the printing in full in repondent's brief of these Sections is to clothe his argument with a show of legislative sanction.

Mr. Justice Frankfurter, in his concurring opinion in *Commissioner* v. *Culbertson, supra,* properly distinguishes the aforesaid Sections of the Internal Revenue Code in relation to one another. No inference can be drawn that they give the Commissioner the power to rewrite agreements between partners when their relation is bona fide. Mr. Justice Frankfurter, in referring to *Lusthaus* v. *Commissioner,* 327 U. S. 293, states, at p. 750, as follows:

> "* * * In short, the opinion did not say that family partnerships are not be be regarded as partnerships for income tax purposes even though they be genuine commercial partnerships; the opinion did not even announce hobbling presumption under the income tax law against such partnerships."

And, continuing, at pages 753-754:

> "* * * It is not for this Court, by redefinition or the election of presumption, to amend the Internal Revenue Code so as to virtually ban partnerships composed of the members of an intimate family group.
>
> * * * * * * * * *

> In plain English, if an arrangement among men is not an arrangement which puts them all in the same business boat, then they cannot get into the same boat merely to seek the benefits of Sections 181 and 182. But if they are in the same business boat, although they may have varying rewards and varied responsibilities, they do not cease, to be in it when the Tax Collector appears."

It is significant to note that *Commissioner* v. *Culbertson,* 337 U. S. 733, was the last case decided by this Court under the rule of *Dobson* v. *Commissioner,* 320 U. S. 489. The *Culbertson* case having been decided by the Court of Appeals on June 30, 1948, prior to the amendment, effective September 1, 1948, of Section 1141 (a) of the Internal Revenue Code, was remanded back to the Tax Court for further consideration. Upon reconsideration, the Tax Court in an opinion by Judge Disney, 9 T. C. Memo. Dec. 647, although speaking the language of this Court's decision failed to apply its principle and Culbertson on second appeal to the Court of Appeals (*Culbertson* v. *Commissioner,* 5 Cir., 194 F. 2d 581, the Court of Appeals applying this Court's decision reversed the Tax Court and the Commissioner did not see fit to seek certiorari again. Similarly in the case at bar, lip service to the decision of this Court in the *Culbertson* case, *supra,* has been made but its principles ignored. The fact that the agreement between the partners gave petitioner a salary of $20,000 per annum comes within what this Court may have inferred in the question left unanswered at page 748. The subsequent amendment of the Internal Revenue Code by Sec. 191 did no more than the partners in the instant case had already done.

Hartz v. *Commissioner,* 8 Cir., 170 F. 2d 313, certiorari denied, 337 U. S. 959, by this Court simultaneously with *Commissioner* v. *Culbertson, supra,* was decided by the

Court of Appeals October 27, 1948, after the effective date of the amendment of Sec. 1141 (a) I. R. C., and this Court, in denying certiorari, did not remand the case to the Tax Court for reconsideration. In view of the holding of the Court of Appeals in *Hartz* v. *Commissioner, supra,* (where, at p. 318, it stated: "* * * Concluding, as we have, that this record compels the conclusion that this was a valid partnership, the Tax Court had no right to re-apportion the income of the partnership between the partners for tax purposes"), and the failure to remand the case in contrast to the *Culbertson* case, it is a reasonable conclusion that this Court upon consideration of the question of the power of the Commissioner to rewrite the agreement of the partners as to the division of profits in a bona fide partnership, would hold in the negative, in line with the Fifth[5], Sixth[6] and Eighth[7] Circuit Courts of Appeal and not follow the decision of the court below.

C. *The Questions in This Case Are of Nation-Wide Interest.* Respondent states that because of the 1948 Revenue Act permitting husband and wife division of income and the 1951 enactment, the question presented by this appeal has lost its nation-wide interest.

This argument fails to observe that petitioner's wife was not made a partner. If petitioner's only purpose was to deflect income from himself then, certainly, it would have been advantageous to have made his wife a partner, for in those years a husband could not merely by filing a joint return with his wife, divide his income in half for tax computation, as at present. Moreover, the 1951 Act in no way eliminates the problem between a father-in-law and his sons-in-law, brothers and sisters, brothers and brothers-in-law, or others not expressly provided for by the 1951

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[5] *Marcus* v. *Commissioner,* 201 F. 2d 850, 853.
[6] *Canfield* v. *Commissioner,* 168 F. 2d 907, 913.
[7] *Hartz* v. *Commissioner,* 170 F. 2d 313.

Act, and the approval by this Court of the usurped power of the Commissioner to substitute his judgment for that of the contracting parties' merely because of a family relationship, would continue to spread.

CONCLUSION

It is respectfully submitted, that because (a) the power asserted by the Commissioner of Internal Revenue is not supported by any authority (b) the conflict of decisions in the Court of Appeals for the various circuits (c) the general importance to the public of the question involved, that there is presented a proper occasion for the exercise of the supervisory power of this Court.

December, 1953.

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